District of Columbia
Department of Consumer and Regulatory Affairs
Insurance Administration
613 G Street, N.W., Washington, D.C. 20001

Opinion and Order

September 24, 1993

Rate Case No. 93-1, In the Matter of the Application of AIPSO for an Increase in the Rates Charged by the District of Columbia Automobile Insurance Plan, Order No. 93-RC-8

Before the District of Columbia Superintendent of Insurance Robert M. Willis, Department of Consumer and Regulatory Affairs, Insurance Administration.

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This matter came before Superintendent of Insurance Robert M. Willis on an appeal of the Property and Casualty Division's recommendation to the Superintendent denying a filing to increase the rates charged by the District of Columbia Automobile Insurance Plan. Both the initial filing and the appeal were filed by the Automobile Insurance Plan Office ("AIPSO") on behalf of the District of Columbia Automobile Insurance Plan ("DCAIP").[1]

I. Procedural History

On April 29, 1992, AIPSO made a filing to increase the insurance rates charged by DCAIP by 13.9 percent. On December 1, 1992, the Insurance Administration, Property & Casualty Division issued a recommendation to the Superintendent to reject the proposed increase based on the grounds that the filing did not "contain sufficient evidence to support a finding that such rates were adequate, not excessive, and not unfairly discriminatory." On December 7, 1992, AIPSO appealed the recommended decision of the Property and Casualty Division by requesting that the Insurance Administration ("Administration") hold a formal hearing on its filing.

On February 26, 1993, the Administration, pursuant to Section 35-1704 of the District of Columbia Code, gave notice of its intent to hold a formal hearing on AIPSO's request and scheduled a Prehearing Conference. See 40 D.C. Register 1566 (1993). The Office of People's Counsel filed a timely notice of appearance and was thereby made a party to this proceeding. No other entity sought to intervene in the proceeding. On March 19, 1993, a Prehearing Conference was held. Based on the written and oral comments, as well as a Joint Proposed Schedule filed by both parties, on April 1, 1993, a Report and Order on Prehearing Conference (Order No. 93-RC-1) was issued which proscribed the issues that were to be adjudicated and the procedures that would govern this proceeding.

A formal evidentiary hearing was held on May 20 and 21, 1993. Prior to the evidentiary hearings, the parties had an opportunity

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[1] While DCAIP is the real party in interest, this action has been prosecuted by AIPSO on behalf of the DCAIP.

to engage in discovery, submitted prefiled testimony and Prehearing Statements consistent with the procedures established in the Report and Order on Prehearing Conference. Subsequent to the evidentiary hearing, the parties filed Posthearing and Rebuttal Briefs supporting their respective positions. The evidence which is deemed part of the evidentiary record for this proceeding was designated in Orders No. 93-RC-5 and 93-RC-7.

II. Discussion

II.A

Issue 1: Is the 13.9% overall rate level change, adequate, not excessive, and not unfairly discriminatory?

The central issue in this proceeding is whether the rates set forth in AIPSO's April 1992 filing comply with the dictates of the District of Columbia Code ("Code"). Section 35-1703(a) of the Code requires that the rates charged by insurance companies "shall not be excessive, inadequate, or unfairly discriminatory." The Administration is also mindful of its obligations under the United States Constitution that insurance companies operating within this jurisdiction be allowed to earn a reasonable rate of return on their business within the jurisdiction. See Calfarm Ins. Co. v. Deukmejian, 48 Cal.3d 805 (1989); State Farm Mutual Automobile Ins. Co. v. State of New Jersey, 124 N.J. 32 (1991); see also Federal Power Comm'n v. Hope Natural Gas, 320 U.S. 591 (1944). The Administration, however, is of the opinion that any rate which satisfies the dictates of the District of Columbia Code will satisfy the requirements of the United States Constitution inasmuch as any rate that is "confiscatory" would be deemed "inadequate" under the Code. To determine whether a rate is excessive or inadequate, or unfairly discriminatory the Administration must examine whether the total income related to a company's District of Columbia operations is sufficient to cover the costs of providing the insurance and to provide a sufficient return on the company's capital. A rate is "excessive" when it will produce a greater return on capital than is required to maintain and attract capital. Conversely, a rate is "confiscatory," but not necessarily inadequate, when it will not provide a sufficient return to maintain and attract capital.

In order to set rates which are neither "excessive, inadequate, nor unfairly discriminatory," the Administration must determine the appropriate rate of return which a company will earn on the capital attributable to its District of Columbia operations. The parties have agreed that the following formula is appropriate for measuring the rate of return earned on the capital attributable to its District of Columbia operations:

$$R_s = (U + I) * P/S + I_n$$

Where:

R_s = Total Rate of Return on Surplus
U = Underwriting profit in relation to premium
I = Investment income on loss, loss expense and unearned premium reserves in relation to premium
P/S= Premium to Surplus ratio
I_n = Investment rate of return

(OPC Ex. 1 at 42-43; AIPSO Ex. 6) The Administration agrees that this formula is appropriate to apply to the issue of rate of return in the context of this hearing. While the parties agree in principle on the above quoted formula, there is considerable disagreement as to the underlying assumptions which should be used in the calculation as well as the rate of return on surplus that should be allowed.

II.A.1 Rate of Return[2]

AIPSO witness Miller asserts that the after-tax rates of return AIPSO would have an opportunity to earn if the filed rates were approved is 7.9% on liability coverage and 6.4% on physical damage. (AIPSO Ex. 6) Mr. Miller, however, noted in the hearing that such a return is far below what would be an appropriate rate of return. Mr. Miller stated that a reasonable rate of return for assigned risk insurance would be in the 16 to 17 percent range. (Tr. at 317)[3] In his prefiled direct testimony, OPC witness Schwartz indicated that an after-tax rate of return between 12.5% and 13% would be appropriate. (OPC Ex. 1 at 42) However, during

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[2] For an insurance company, rate of return can be calculated on at least two bases: statutory surplus or GAAP net worth. The figures cited in this Order refer to a return on statutory surplus unless otherwise indicated. In general, a return on statutory surplus is 20% greater than a return on GAAP net worth. (Tr. at 317)

[3] Formal hearings were held in this proceeding on May 20, 1993, and May 21, 1993. In this order references to the transcript of the hearing are abbreviated as Tr. at ____.

the hearing, Mr. Schwartz testified that a reasonable rate of return for assigned risk business would be in the 11 to 14 percent range.\4 (Tr. at 419)

While both Mr. Miller and Mr. Schwartz provided some theoretical justification for their respective positions, the Administration is concerned by both the amount and quality of the testimony that was offered on this issue. Although the Administration respects the efforts of these witnesses, it was noted that neither was a financial expert or had conducted a detailed analysis of the current financial markets. In the future, the Administration hopes that the parties will provide a more thorough analysis in support of their positions on a reasonable rate of return. While neither of the witnesses is a financial expert, both are experienced actuarial witnesses in insurance rate proceedings and, as such, are familiar with the rate of return concept and the rates of return allowed in other proceedings.

Although the evidence presented on this issue is not as compelling as the evidence presented on the other issues in this proceeding, the Administration concludes there is a sufficient basis upon which to make a determination of an appropriate rate of return. First, the Administration notes that the rate of return ranges selected by the witnesses are not greatly dissimilar. Mr. Miller argued that the appropriate return would be in the 16 to 17 percent range, while Mr. Schwartz argued in favor of an 11 to 14 percent range. In particular, the difference between the upper limit selected by Mr. Schwartz and the lower limited selected by Mr. Miller is only two percent. In situations such as this, it may be appropriate to select a number midway between the ranges provided by the two witnesses. See Tennessee Gas Pipeline Co. v. FERC, 926 F.2d 1206, 1209 (D.C. Cir. 1991).\5 The Administration,

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\4 Mr. Schwartz testified that his estimate was supported by (i) the historical profit experience for the property/casualty insurance industry, (ii) the capital asset pricing model, (iii) a discounted cash flow analysis, (iv) the degree of risk for the property/casualty business compared to the degree of risk for the entire economy, and (v) the fact that private passenger automobile insurance is less risky than other lines of insurance. (OPC Ex. 1 at 43). Mr. Schwartz's testimony does not provide any support for these assertions.

\5 In Tennessee Gas Pipeline Company, the United State Court of Appeals for the District of Columbia Circuit noted that:

> The Commission's approach to estimating the cost of equity capital appears to be a

(continued...)

however, is cognizant of the current depressed state of the capital markets, and thus, believes it is appropriate to adjust such a midway rate of return downward. (Tr. at 419) In light of these factors, the Administration determines that an overall after-tax rate of return of 12% is appropriate.

The Administration also notes that the decisions of other regulatory bodies support a finding that a 12% rate of return is appropriate. A 12% return on statutory surplus translates to approximately a 9.6% return on GAAP net worth. In the most recent rate case decided by the Public Service Commission of the District of Columbia, a return on capital of 9.96% was allowed. See Formal Case No. 912, Order No. 10044 (D.C.P.S.C. June 26, 1992). A 9.6% return on GAAP net worth is consistent with the returns currently allowed by other Insurance Departments. The most recent reported decisions of which the Administration is aware have allowed returns on GAAP net worth of approximately 10.0%. See Allstate Ins. Co. v. Foster, 605 A.2d 1294 (Pa. Cmwlth. Ct. 1992) (upholding 10.4% return on GAAP); Cal. Admin. Code, tit. 10, § 2645.6(a) (setting 10.0% as minimum rate of return).

The decisions of the other bodies were decided, on average, more than a year ago and based on data that is more than one year old. Given that capital markets since that time have declined, it is appropriate that the rate of return allowed in this proceeding is lower than those allowed by earlier cases.

While the Administration hereby determines that a 12% after-tax return on statutory surplus is appropriate for this proceeding, the Administration cautions the parties that a similar rate of return will not be automatically allowed in future filings. The Administration will exercise its authority to adjust rate levels

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\5(...continued)

> two-step process, in which it first frames a zone of reasonableness with the estimation tools of its choice. Then, in the absence of evidence that leads the Commission to prefer one estimate over the other, it sets the rate of return at the average of those boundary figures. If "other factors" warrant a preference one way or the other, the Commission makes a suitable "pragmatic adjustment."
>
> We have no quarrel with this general methodology.

926 F.2d at 1209.

between rate classes to provide an overall rate structure allowing a company the opportunity to earn a fair return on its District of Columbia operations. Cf. California Automobile Assigned Risk Plan v. Gillespie, 7 Cal.App.4th 266, 280 Cal. Rptr. 217 (1991)[6]. The Administration hereby places the parties on notice that in future rate filings the parties shall address the relationship between the voluntary and the residual markets in determining the appropriate rate of return for assigned risk business.

II.A.2 Premium to Surplus Ratio

OPC witness Schwartz testified that a premium to surplus ratio of 2.0/1.0 is commonly used and is appropriate to calculate the required rate of return. (OPC Ex. 1 at 43) AIPSO witness Miller, on the other hand, recommended a premium to surplus ratio of 1.7/1.0. (See AIPSO Ex. 6) Mr. Miller testified that this ratio is based upon the figures published in A.M. Best's most recent Aggregates and Averages. (Tr. at 264). The Administration believes that a premium to surplus ratio of 2.0/1.0 should be used to calculate the rate of return. This factor is commonly accepted in the insurance industry and is more likely to represent the long-term relationship between premium and statutory surplus than the ratio proffered by Mr. Miller. See Cal. Admin. Code, tit, 10, § 2645G(b) (adopting 2/1 ratio for private passenger auto liability); In re North Carolina Rate Bureau, N.C. Dep't of Ins. Docket No. 535, at 27-28 (Dec. 29, 1989).

II.A.3 Investment Income

The investment income return (I_n) represents the return an insurance company will yield on its invested funds. (OPC Ex. 1 at 43) OPC witness Schwartz testified that a "reasonable range" for investment income return is in the 5.5% to 6.0% range. (OPC Ex. 1 at 43). Given the current state of the capital markets, the Administration believes the lower figure is appropriate in this instance. The Administration hereby adopts 5.5% as the appropriate return on invested funds for the purposes of this decision.

\6 While the California Court of Appeals for the Fourth District was interpreting the California Insurance Code in California Automobile Assigned Risk Plan v. Gillespie, its analysis is instructive inasmuch as the wording of the California statute is similar to the rate provisions of the District of Columbia Code. Compare District of Columbia Code § 35-1703(a) with Cal. Ins. Code § 1861.05.

II.A.4 Insurance Operating Profit

Insurance operating profit (U+I) consists of two components: the underwriting profit ("U") and the investment income on loss, loss expense and unearned premium ("I"). According to Mr. Miller, an insurance company has three sources of income:

> First of all, the underwriting operation. That's the difference between the premium collected and the losses and expenses paid out; and the net is called the underwriting profit or loss.
>
> Then we have the second source of income. That is subdivided, most often, into two components: investment and income that comes from collecting premiums and holding them for a while until claims are paid. The investor holds the funds which are from policyholder supplied funds because the customers have paid in advance for the coverage, and they should get some kind of credit for that.

(Tr. at 176) The sum of the underwriting profit and the investment income on policyholder supplied funds represents a company's insurance operating profit.[7] (Tr. at 177) For purposes of this Order, the sum of these figures shall be referred to as the return on insurance operations. Both AIPSO witness Winkleman and Miller assert that the rate filing would produce a return from insurance operations of 0%. (Tr. at 39 (Winkleman); Tr. at 180 (Miller)) OPC witness Schwartz testified that a return on insurance operation of 3.5% is appropriate, (OPC Ex. 1 at 42) and appears to argue that AIPSO's filing represents a return on insurance operations in excess of 3.5%.

While the parties agree on the process for computing a return on insurance operations, their respective witnesses disagree on the facts which underlie the calculation. The positions of the parties is discussed below.

II.A.4.1 Contingency Factor

AIPSO included in its original filing a "contingency factor" of 5%. AIPSO witness Miller asserts that the contingency factor is

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[7] The final source of income is investment income generated by a company's capital and surplus. (Tr. at 177) This component of a company's income is not reflected in the operating profit, but is included in the rate of return formula. In terms of the rate making formula, it is represented by the variable "I_n."

intended to cover expenses and losses which would not otherwise be predicted in the ratemaking process, but which are certain to occur. (Tr. at 197-99) Mr. Miller argues that there is a downward bias in the ratemaking process and that the contingency factor is designed to correct this bias.\8 (Id.) In response to questions from the Superintendent, Mr. Miller proffered AIPSO exhibit 3-A in support of his contention that there is a systemic downward bias in the ratemaking process.\9 Mr. Miller asserts that AIPSO exhibit 3-A demonstrates that automobile insurance companies operating in the District of Columbia have experienced an operating return of roughly 0% between 1985 and 1991. He further testified that it was highly unlikely that the companies intended to generate an operating return of 0% and therefore concludes that there is a systemic downward bias. Mr. Miller, however, did not purport to quantify the extent of the downward bias.\10 (Tr. at 205-06)

OPC witness Schwartz testified that the contingency provision was improper. The thrust of Mr. Schwartz's position appears to be that the expenses intended to be captured in the contingency provision will not materialize and that, therefore, the contingency provision is simply another form of profit.\11 (Tr. at 386-87)

While the Administration is cognizant of an inherent degree of uncertainty in the ratemaking process, it believes the inclusion of

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\8 During the hearing, Mr. Miller testified that

> That's what the contingency does. All it does is says - look, if I could do a better job of predicting losses and expenses, I would not need a contingency provision. This is the thing that corrects the bias, in the case of auto insurance, the downward bias for the projection process . . . .

(Tr. at 199)

\9 The complete report was accepted into the record at the conclusion of the Formal Hearing in this matter. See Order No. 93-RC-7.

\10 Mr. Miller indicated that he was not aware of the intended targets for the operating return during the 1985 to 1991 period. He suggested that, based on his experience, this return was probably somewhere in the 3 to 6 percent range. (Tr. at 206)

\11 AIPSO witness Miller admitted that in the event the expenses covered by the contingency do not materialize, the contingency would become profit. (Tr. at 201)

a 5% contingency factor in the ratemaking formula is inappropriate. The burden of proof in this proceeding is on AIPSO, see District of Columbia Code § 35-1703(f)(2), and, on this issue, AIPSO has simply failed to meet its burden. By Mr. Miller's own admission he was unaware of the intended operating return during the 1985-91 period. Thus, even if the Administration were to accept his concept,\12 AIPSO has failed to quantify the magnitude of an appropriate contingency factor or to justify the need for a contingency factor in the ratemaking process. Accordingly, the contingency factor will not be allowed in the calculation of AIPSO's rates.

II.A.4.2 Expenses

The parties disagree as to the appropriate expense levels that should be included in an estimate of an insurance company's underwriting profit. The issue of the appropriate level of expenses is considered in Issue No. 7. See section II.H. The Administration will use the level of expenses set forth in section II.H of this Order in calculating the appropriate rate of return.

II.A.4.3 Loss Trend Factors

The rate filing was based on historical loss experience that was trended into the future to arrive at an estimate of future losses that will be incurred. (AIPSO Posthearing Brief at 11-12) AIPSO witnesses Winkleman and Miller testified that the underlying historical data as well as the trending used in the filing are appropriate. (AIPSO Ex. 1; AIPSO Ex. 2 at 7) AIPSO witness Winkleman testified that for liability coverages\13 two years of data were used with the most recent year being weighted 85% and the earlier year being weighted 15%. For physical damage coverage two years of data were also used but the weighting was 70% and 30%. (Tr. at 30-31) Mr. Winkleman further testified that the weighting factors selected were based on a credibility table\14 developed by AIPSO. (Tr. at 32)

\12 Mr. Miller appears to argue that the size of the contingency factor should be equal to the difference between the intended return on insurance operations and the actual return on insurance operations that was generated during the rate effective period.

\13 Liability coverages include bodily injury, property damage, uninsured motorists, and personal injury protection. (Tr. at 29)

\14 According to Mr. Winkleman, the weighting factors in the credibility table are based on the volume of premium in any given year. (Tr. at 32)

OPC witness Schwartz argues that the loss trend data selected by AIPSO is inappropriate. Mr. Schwartz testified that there were several reasons why the data selected by AIPSO should be rejected. Mr. Schwartz argues the trend factors are excessive because: (i) AIPSO's trend selections do not reasonably reflect the actual experience, (ii) AIPSO has ignored the fact that a considerable portion of uninsured motorist ("UM") losses are for property damage instead of bodily injury and (iii) AIPSO has not appropriately reflected the combined physical damage trend experience for collision and comprehensive together. Each of these contentions will be discussed in turn.

Trend Factor Selection. OPC witness Schwartz argues that AIPSO should have used Fast Track data in its analysis.\15 He notes that Fast Track trend data is collected for the National Association of Insurance Commissioners (NAIC) by Insurance Services Office (ISO), the National Association of Independent Insurers (NAII) and the National Independent Statistical Service (NISS). These data are collected in order to provide recent frequency, severity and pure premium data for private passenger automobile insurance across a broad spectrum of the market.\16 (OPC Ex. 1 at 11)

Mr. Schwartz notes that Fast Track data is a generally accepted source of information used to analyze trends for private passenger automobile insurance. Mr. Schwartz argues that Fast Track data should be included for the following reasons. First, Fast Track trend data are more recent than the trend data included in AIPSO's revised rate level calculation. According to Mr. Schwartz, Fast Track data contains claims experience through the year ending December 31, 1992, while ISO data only includes claims experience through to June 30, 1992. Second, Fast Track data constitutes a larger share of the overall private passenger automobile insurance market in the District of Columbia and countrywide as opposed to the ISO trend data included in the AIPSO filings. Moreover, Mr. Schwartz notes that a major part of the reason why the ISO/AIPSO trend database is so much smaller than that for Fast Track is because this database does not contain information for the three largest writers of private passenger automobile insurance in the District of Columbia (GEICO, State Farm and Allstate). Third, Fast Track trend data is available for collision and comprehensive physical damage coverages. Physical

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\15 Mr. Schwartz recommends that a trend factor of 6% be used. (OPC Ex. 1 at 16)

\16 Specifically, OPC witness Schwartz proposed a weighted average of ISO and Fast Track data. (OPC Ex. 1 at 16-19)

damage trend data is not included in the AIPSO original or updated rate calculations. (OPC Ex. 1 at 11-13)

In rebuttal, AIPSO witness Miller asserted that the trend data contained in the filing was appropriate. Mr. Miller agreed that Fast Track data is important and that it should be considered in a rate filing. Mr. Miller explained that he had considered Fast Track data in his review of the AIPSO filing and that he believed the Fast Track data supported the conclusions reached by AIPSO. Mr. Miller also explained that while Fast Track data is important, it is not subject to the level of screening which is done for ISO data and therefore contains more errors. Finally, Mr. Miller noted that the ISO data pertains to basic limits policies while the Fast Track data pertains to all types of automobile coverages. Mr. Miller notes that assigned risk coverage is more likely to be written at basic limits, and therefore, concluded that the ISO data is more representative of the actual risks in the assigned risk market. (Tr. at 129, 165-68 & 305)

On the issue of selection of trend factors, the Administration finds Mr. Schwartz's testimony more persuasive. AIPSO's proposed trend factors were mathematically based exclusively on ISO data. ISO data represents only a third of the District of Columbia experience and fails to incorporate data from the three largest private passenger automobile carriers in the District of Columbia. Given that other sources of data, such as the NAII data, are available, the Administration determines it is appropriate to use a larger universe of data in the rate calculations. Since the approach proffered by Mr. Schwartz is based on a larger universe of data, the trend factors he recommended will be utilized.

U/M Trend Factor. OPC witness Schwartz argues that AIPSO has not taken into account the fact that a significant portion of uninsured motorist (UM) losses arise from property damage liability claims as opposed to bodily injury liability claims. OPC witness Schwartz recommends a trend factor for the UM coverage of 4.5%. Mr. Schwartz argues that as trend data is not available from either Fast Track data or ISO, the trend for UM should be based on comparable coverages. In many states, the BI trend is used for the UM coverage. (OPC Ex. 1 at 19-20)

According to Mr. Schwartz, however, such an approach is inappropriate in the District of Columbia. Witness Schwartz notes that in the District of Columbia, a substantial amount of UM losses do not involve bodily injury ("BI") claims. According to Mr. Schwartz, a large amount of UM losses are property damage ("PD") claims. Based upon information supplied in response to data requests, Mr. Schwartz estimates that about 75% of UM losses are for BI claims and 25% for PD claims. Therefore, Mr. Schwartz recommends that the BI annual trend of 6% and the PD annual trend

of 0% be combined using weights of 75% and 25%, respectively. This approach results in an annual pure premium loss trend factor for UM of 4.5%. (OPC Ex. 1 at 20)

In rebuttal, AIPSO witness Miller testified that the approach adopted by AIPSO was customary and commonly used in the industry. Thus, Mr. Miller concluded that the approach was actuarially sound and appropriate for this filing. (Tr. 454-55) Moreover, Mr. Miller noted that ISO has reviewed the relationship between bodily injury claims and uninsured bodily injury claims and found that uninsured claims are approximately 13.6% higher. Based on this relationship, Mr. Miller proffered AIPSO exhibit 15. According to Mr. Miller, AIPSO exhibit 15 shows that if this relationship is incorporated into the methodology proposed by Mr. Schwartz and the data contained in the updated filing is used, the indication for uninsured motorist coverage would exceed that requested by AIPSO. (AIPSO Posthearing Brief at 17) Thus, Mr. Miller contends that the requested trend factor is appropriate.

The Administration finds the testimony of Mr. Schwartz persuasive.

UM & PIP Experience Period. AIPSO used a two year experience period in the filing to calculate the rate level indications for the UM and PIP coverages. AIPSO witness Miller testified that the experience period contained in the filing was reasonable. (AIPSO Ex. 2 at 6) OPC witness Schwartz argued that, with respect to the UM and PIP coverages, a two year experience period contained insufficient data to be credible and recommended a three year period. (OPC Ex. 1 at 50-54)

The Administration finds Mr. Schwartz's testimony persuasive, and therefore, the Administration directs AIPSO to use three years of experience in its determination of the rate level indications for these coverages.\17

Comprehensive Trend Factor. OPC witness Schwartz recommends a 0% trend factor for comprehensive. Mr. Schwartz argues that AIPSO improperly used a different trend factor for comprehensive than it did for collision. Mr. Schwartz notes that AIPSO used a 0% trend for collision, which is above the historical negative trends. For comprehensive AIPSO used a 2.2% annual trend, which is fairly consistent with historical experience. Mr. Schwartz argues that it is inappropriate to use separate trend factors. He notes that the only relevant trend for this filing is the combined collision and comprehensive value, not the trends for the individual

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\17 As is more fully explained in section II.C of this Order, the increase for the U/M coverage was capped at 60%.

coverages. This is because the rate calculations as performed by AIPSO are for the combined physical damage coverages, not for the individual component coverages. (OPC Ex. 1 at 22)

Mr. Schwartz argues that the combined trend factor should be 0%. He notes that the historical trend for collision has been less than 0%, while that for comprehensive has been above 0%. When the historical trend for collision and comprehensive are combined using a 70/30 weighting, the combined indicated average annual pure premium trend ranges from slightly negative to 0%. Based upon this finding, Mr. Schwartz concludes that a 0% trend for collision and comprehensive should be used. (OPC Ex. 1 at 22-23)

The Administration finds the testimony of OPC witness Schwartz persuasive.

II.A.4.4 Loss Development Factors

AIPSO's estimate of incurred losses included loss development factors ("LDFs"). AIPSO witness Winkleman testified that the LDFs used in AIPSO's filing were based on historical loss development data.[18] Both AIPSO witnesses Winkleman and Miller testified that AIPSO's proposed LDFs were calculated in a manner that is commonly used by the actuarial profession and which produces reliable results. (AIPSO Ex. 1 at 9-10; AIPSO Ex. 2 at 8-9) OPC witness Schwartz testified that AIPSO's LDFs were inappropriate and resulted in excessive rates. (OPC Ex. 1 at 25-26) According to Mr. Schwartz, AIPSO should have used a weighted average to calculate the LDFs rather than an unweighted average as AIPSO did. Mr. Schwartz testified that a weighted average was the "mathematically . . . correct." (OPC Ex. 1 at 25-26)

In rebuttal, AIPSO witness Miller testified that there is no one correct approach to determine LDFs, rather that the decision to use weighted or unweighted factors was really a question of actuarial judgment. (Tr. at 210-12) In this light, Mr. Miller noted that four of the five data points resulted in positive development, while only one data point resulted in negative development. Mr. Miller observed that because the methodology advocated by Mr. Schwartz resulted in negative development for one

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[18] LDFs are necessary because there is a time lag between the event that triggers a loss occurs and the time the ultimate amount of the loss is known by the insurance company. Even for losses that occurred two years ago "[s]ome losses - known as incurred but not reported (IBNR") claims - have not yet been reported to the insurance companies, while other losses have been reported but will have further modifications made to their reserves." (AIPSO Posthearing Brief at 7)

point, (Tr. at 469-70) he should have selected an alternative approach since the result was contrary to the majority of the data.

The Administration finds Mr. Miller's testimony persuasive. The determination of whether to use weighted or unweighted factors is one of actuarial judgment. Both AIPSO witness Winkleman and AIPSO witness Miller testified as to why they selected the approach they did. Mr. Schwartz, on the other hand, did not explain the rationale which led him to the conclusion that a weighted approach was better in this instance. Since AIPSO has explained and supported the actuarial judgment underlying its selection of LDFs and Mr. Schwartz has relied on conclusory statements, the Administration finds that the LDFs proposed by AIPSO are more appropriate for use in this proceeding.

II.A.4.5 Trending

AIPSO witness Miller recommended that AIPSO's April 1992 filing be trended forward to reflect an effective date of August 1993. He noted the original filing assumed an effective date of July 1, 1992 and that such a date is no longer realistic. Witness Miller asserted that trending is a straightforward calculation, (AIPSO Ex. 2 at 7) which effectively increases the amount of the originally requested rate increase to 21.8%.

On brief, OPC contended that the Administration cannot authorize an increase in excess of the originally filed 13.9%. (OPC's Reply Brief at 9-11). OPC argued that the notice announcing this hearing indicated AIPSO had requested a 13.9% increase and that as a result the public was not put on notice that AIPSO was actually requesting an increase in excess of 13.9%. Accordingly, OPC asserted that, in the event an increase in excess of 13.9% were allowed, the public was not given adequate notice as required under the District of Columbia Administrative Procedures Act. See District of Columbia Code § 1-1501 et seq..

The Administration finds Mr. Miller's recommendation practical and realistic and will trend the data forward to an effective date of September 1, 1993. The Administration is hereby authorizing a total increase of 7.6%, which includes trending forward to the September 1, 1993, effective date. However, in order to provide guidance to the parties in future proceedings, the Administration notes that OPC's reading of the notice provision is inconsistent with the provisions of the Code. Section 35-1704(c) of the Code states that:

> [i]f after such hearing the Superintendent determines that any or all of such rates are excessive or inadequate, he shall order appropriate adjustment thereof.

The Code, therefore, contemplates that the Superintendent has the authority to adjust rates both upward and downward after a rate hearing such as this one. Additionally, the Notice of Hearing announcing this proceeding indicated that the Administration would determine whether the rates proposed by AIPSO were "inadequate, excessive or unfairly discriminatory", and thus, the parties and the public were put on notice that an upward adjustment was possible.

Based on the foregoing adjustments to AIPSO's April 1992 filing, the Administration therefore determines that the requested increase, as trended, of 21.8% would result in excessive rates. The Administration also determines that an increase of 7.6% would result in rates that are neither excessive or inadequate inasmuch as such a level allows DCAIP to earn an appropriate rate of return.

II.B

Issue 1(a): Are the established rating factors unfairly discriminatory?

In Order No. 93-RC-3, the Administration determined that OPC would bear the burden of proof on this issue inasmuch as OPC is challenging an established procedure that has been previously approved by the Administration. On brief and during the hearings, OPC and its witness asserted that DCAIP's current rating plan is discriminatory, particularly with respect to young, unmarried males. In Order Number 93-RC-1, the Administration determined that OPC would have the burden of persuasion on this issue. OPC did not present evidence demonstrating that the existing rate classifications are "unfairly discriminatory".

OPC witness Schwartz testified that for five rating classifications[19] bodily injury loss ratios were 20% better than average. For one classification, class 2B, the bodily injury loss ratio is 20% worse than average. Based on this analysis, Mr. Schwartz concludes that the rate relativities should be adjusted. (OPC Ex. 1 at 54-55) On brief, OPC compared the rate relativities used by the Maryland Automobile Insurance Fund (MAIF) in Baltimore, Maryland and concluded that since the District of Columbia relativities are higher than those used by MAIF, these

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[19] Rating classifications establish the definitions of rate classes. Typically, classes are defined in terms of age, gender and marital status. Classes are charged different rate levels based on the risk incident to the individuals in each class.

relativities\20 are discriminatory. (OPC's Posthearing Brief at 21-22)

In response, AIPSO witness Winkleman testified that the data relied upon by Mr. Schwartz is insufficient in volume to be actuarially credible. (AIPSO Ex. 1 at 22-23) On brief, AIPSO argued that OPC has failed to introduce evidence proving that the variance between MAIF's rate relativities and DCAIP's rate relativities demonstrates that DCAIP's rating factors are discriminatory. Specifically, AIPSO notes that no attempt was made to show that the MAIF factors are accurate, appropriate or nondiscriminatory. AIPSO also notes that MAIF uses different rating classifications than those used by DCAIP. (AIPSO Reply Brief at 22-25)

The Administration finds that OPC did not present sufficient credible evidence to meet its burden with regard to this issue. As AIPSO properly argues, (AIPSO Reply Brief at 22-25) most of the contentions put forward by OPC were raised for the first time in OPC's Posthearing Brief and lack any credible evidentiary support. The only evidence put forward by OPC was Mr. Schwartz's analysis. However, by this witness' own admission, the analysis was cursory in nature and, as AIPSO witness Winkleman testified, was based on a sample size of questionable actuarial credibility.

For the reasons set forth in AIPSO's Reply Brief, the Administration finds the comparison between the MAIF rating factors and those used by DCAIP unpersuasive. OPC did not establish any of the factual predicates necessary to lead to a conclusion that the DCAIP relativities are unfairly discriminatory. Moreover, OPC did not demonstrate that the MAIF rating factors are similar to the rating factors used by DCAIP. Thus, no determinable conclusions can be drawn from the comparison of these factors.

II.C

Issue 2: Is the 130.6% rate level change for uninsured motorist coverage unfairly discriminatory because it would be applicable to all policy holders regardless of the insurance limits of individual policyholders?

AIPSO witness Miller testified that the indicated rate change of 130.6% contained in the original filing for uninsured motorist coverage does not produce unfairly discriminatory rates. Mr. Miller noted that the proposed increase is based on a review of basic limits data and is being applied to the lower limits of

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\20 Rate relativity refers to the difference between the rates charged various classes.

coverage. For coverage above the basic limits, the basic limit cost is added to a fixed amount (the dollar additive amount) to derive the rates for the higher policy limits. The dollar additive amounts are not being changed. (AIPSO Ex. 2 at 18-19)

OPC did not present any evidence on this issue. Mr. Miller's testimony demonstrates that the cost increase is attributable to the basic limits portion of the uninsured motorist coverage which is included in all uninsured motorist policies, regardless of their coverage limits. The Administration, therefore, determines that the proposed rate is not unfairly discriminatory.

While the Administration finds the proposed increase in the uninsured motorist premium has been quantified on a pure mathematical basis, the Administration determines that an increase of this magnitude is inappropriate at this time. The requested increase would roughly triple the current premium for uninsured motorist coverage. It is important that insureds in this jurisdiction are protected from dramatic rate changes of this magnitude.

As such, the Administration will allow a 60% increase in the uninsured motorist rates. Although the effect of this decision is to limit the proposed rate indication and thereby decrease the rate of return, the effect of this limitation has been reflected in the calculation of the overall rate of return allowed in this proceeding.\21 Provided the overall rate of return is not confiscatory, the Administration has the authority to alter the internal rate indications of the various lines of coverage. Other departments have made similar adjustments in order to insure that rates are affordable for all customer classes. For example, in Massachusetts Automobile Rating v. Commissioner of Insurance, 424 N.E.2d 1127, 1134 (1981), the Commissioner of Insurance for the Commonwealth of Massachusetts made an "equitable adjustment" from the rates that would otherwise have been indicated by the loss ratio in order to insure affordable insurance.

\21 The Administration determined that a 12.0% rate of return was appropriate for this proceeding. See supra section II.A.1. The Administration notes that the impact of the limited U/M rate increase has been included in its calculation of the appropriate rate of return.

II.D

Issue 3: Are higher uninsured motorist premiums for policyholders not purchasing medical expense coverage justified?

AIPSO witness Miller argues that it is reasonable that the rate would be higher for insureds without medical coverage, because such insureds will utilize their uninsured motorist coverage more often and to a greater extent than will the insureds with the medical coverage. Further, Mr. Miller notes that the existing differential was filed and approved in 1986, and AIPSO has no loss experience which can be reviewed to determine if the existing differential should be revised. (AIPSO Ex. 2 at 18-19)

OPC presented no evidence on this issue. The Administration finds the testimony of Mr. Miller persuasive and therefore orders no adjustment in the rate with respect to this issue.

II.E

Issue 4: Were the uninsured motorist premiums at present rates as shown on Exhibit III, Sheet 2, calculated incorrectly because the present manual rate has been based on limits of 25/50/10 even though the mandatory basic limit coverage in the District of Columbia is 25/50/5?

AIPSO witness Miller testified that the premiums at present rates were calculated at a coverage limit of $25/$50/$10, rather than the mandatory basic limit of $25/$50/$5. Mr. Miller further indicated that the losses used in the calculation of the rate change indication were correctly stated at the mandatory basic limit of coverage and that as a result the premiums were slightly overstated, leading to an understatement of the rate change indication. Lastly, Mr. Miller noted that the indicated rate change would be approximately 5.7% higher had the present rates been calculated at the mandatory basic limit. (AIPSO Ex. 2 at 19-20)

OPC presented no evidence on this issue. The Administration finds the testimony of Mr. Miller persuasive and therefore orders no adjustment in the rate with respect to this issue.

II.F

Issue 5: Did AIPSO fail to reflect properly in its physical damage rate analysis the rate level effect of each new model year?

AIPSO witness Miller argues that the filing properly reflects the effect of each new model year. According to Mr. Miller, the issue is whether AIPSO's delay in implementing higher rates for 1991 models somehow affected the indicated physical damage changes in this filing. The rating procedure applied to 1991 models had minimal, or no impact on the 1989 and 1990 experience underlying this filing. Mr. Miller noted, however, that the effect of the physical damage rate changes implemented by AIPSO for 1991 models must be reflected in future filings which rely on a later experience base. (AIPSO Ex. 2 at 20)

OPC presented no evidence on this issue. The Administration finds the testimony of Mr. Miller persuasive and therefore orders no adjustment in the rate with respect to this issue.

II.G

Issue 6: If incurred losses for uninsured motorists were properly reflected at the limits of 25/50/5, what impact would that have on the rate indication?

For the reasons set forth above in response to Issue 4, the Administration determines that no adjustment to the proposed rates are appropriate with respect to this issue.

II.H

Issue 7: Is the level of expenses reflected in the rate filing reasonable?

AIPSO witnesses Winkleman and Miller testified that the level of expenses reflected in the filing is appropriate. (AIPSO Ex. 1 at 13-17; AIPSO Ex. 2 at 9-12) OPC witness Schwartz, on the other hand, testified that the filing assumed expense levels that are inappropriate. In particular, Mr. Schwartz questioned the following expense levels:

1. the level of acquisition and general expenses;

2. the level of variable expenses; and

3. AIPSO's contention that expense levels should be increased by a loading factor of 25%.

(OPC Ex. 1 at 32-40). With the exception of these three issues, Mr. Schwartz agrees that AIPSO's expense calculations are appropriate. Since the parties are in agreement with the bulk of the claimed expense levels, this Order will discuss only the issues where the parties disagree.

II.H.1 Acquisition & General Expenses

OPC witness Schwartz testified that in the residual market, an agent is used and a commission is paid on all policies. According to Mr. Schwartz, however, this is not true for the entire private passenger automobile insurance market. In the voluntary market, many insurance companies do not use agents to whom commissions are paid. As to these companies, employees perform work that would otherwise be handled by agents. This method of operation lowers commissions, but raises a company's acquisition and general expense costs. (OPC Ex. 1 at 32-34).

Mr. Schwartz indicated that the difference between the way insurance is marketed in the residual and voluntary markets causes an upward bias in AIPSO's estimate of acquisition and general expenses. Since AIPSO derived its estimate of acquisition and general expenses from the entire private passenger market, Mr. Schwartz testified that the estimated expense levels are excessive in that they include marketing costs that are not applicable to the residual market (i.e. the expenses for those companies that do not use agents in the voluntary market). (Id.)

In rebuttal, AIPSO witness Miller acknowledged that some deduction was appropriate for the services performed by agents, but testified that the 20 percent reduction recommended by OPC witness Schwartz is too high. (AIPSO Posthearing Brief at 18-19) In support of this contention, Mr. Miller noted that the actual commission rate is not ten percent as indicated by Mr. Schwartz, but rather approximately 9 percent. (Tr. at 471)

The Administration finds the testimony of Mr. Miller persuasive and determines that AIPSO's proposed acquisition and general expenses were calculated based on actuarially sound methods. The Administration therefore determines that AIPSO proposed estimates of acquisition and general expenses are appropriate.

II.H.2 Expense Loading

AIPSO witness Miller testified that general and other acquisition expenses were based on the countrywide average ratio of general and other acquisition expenses from the latest three years of data published in Best's Aggregates and Averages. This average expense ratio is then increased by a factor of 1.25 to reflect the

fact that residual market business incurs a higher level of expenses than business written voluntarily. (AIPSO Ex. 1 at 10-12) OPC witness Schwartz questions the propriety of this expense loading. Witness Schwartz argues that it is inappropriate to increase the expense factor by 25% over the voluntary market as is advocated by AIPSO witness Miller. Mr. Schwartz notes that even if one assumes that AIPSO's assertion is true, it does not justify a higher percentage expense loading. (OPC Ex. 1 at 34-36)

In rebuttal, AIPSO witnesses Winkleman and Miller contend that AIPSO has conducted a study showing that the expense ratio in the residual market were 150% higher than that in the voluntary market. (AIPSO Ex. 1-E) The study indicates that not only is the absolute level of expenses higher for the residual market, but the ratio itself is higher. (Id.) AIPSO witness Miller also testified that, based on his experience, in general the expense ratio is higher for the residual market. (Tr. at 139-41)

The Administration finds the testimony of Mr. Miller and AIPSO exhibit 1-E persuasive. Since the record demonstrates that the expense ratio is higher in the residual market, AIPSO's loading factor is appropriate.

II.H.3 Variable Expenses

OPC witness Schwartz testifies that it is inappropriate for AIPSO to base their trend for non-variable expenses totally upon the inflation in wages paid by insurance companies. In doing this, AIPSO ignored the fact that a large portion of insurance company expenses go for items other than wages. Witness Schwartz recommends that analysis of the non-variable expense trend should consider both the change in the average weekly wage for fire, marine and casualty insurance along with inflation as reflected by the CPI. (OPC Ex. 1 at 38-39)

AIPSO witness Miller testified that AIPSO's proposed expenses are appropriate and were calculated in an actuarially sound fashion. The Administration finds the testimony of Mr. Miller persuasive, and therefore, no adjustment is necessary with regard to the variable expenses.

II.I

Issue 7(a): Should AIPSO's rates be based upon the experience of the most efficient 25 percent of the insurance companies operating in the AIPSO plan?

By the Insurance Administration's Memorandum and Order on Issue 7(a) (Order No. 93-Rc-3) this issue was deleted from the

Issues to be adjudicated in this proceeding. As such, Issue No. 7(a) is moot and is not discussed herein.

II.J

Issue 8: Do the frequency trend factors exclude accidents involving individuals insured in jurisdictions other than the District of Columbia when those accidents occur within the District of Columbia and the out-of-District individual is at fault?

AIPSO witness Miller argues that the District's trend data reflects only the claim payments made to and on behalf of those insured under District policies. He notes, for example, if a Virginia insured damages the car of a District insured, the District insured recovers from the Virginia insured's property damage liability coverage and such claim payments are recorded as a Virginia claim loss and do not enter into the District's trend data. By the same token, if the District insured caused a similar accident in Virginia, the reverse treatment of the claim payment would apply. (AIPSO Ex. 2 at 7-8)

OPC failed to brief or present any evidence pertaining to this issue. Based on Mr. Miller's testimony, the Administration determines that the impact of non-District residents does not cause the rate increase requested by AIPSO to be excessive.

II.K

Issue 9: How do the statutory limits required in Maryland and Virginia compare with those in force in the District of Columbia and what rate levels would apply in Maryland and Virginia assuming the statutory limits were identical with those currently in force in the District of Columbia?

AIPSO witness Miller testifies that the mandatory BI/PD basic limits in the District are $25/$50/$10 and that in Virginia and Maryland, the basic limits are $25/$50/$20 and $20/$40/$10, respectively. Mr. Miller estimates that if the District were to adopt Virginia's basic limits of coverage, the District's property damage liability rates would increase approximately 3%. If the Maryland basic limits were adopted, the bodily injury liability rates would decrease approximately 3%. (AIPSO Ex. 2 at 20-21)

Mr. Miller notes that the minor differences in the mandatory BI/PD limits of coverages do not explain the difference between the rates charged in the three jurisdictions. According to Mr. Miller, the major factor which increases the cost of coverage that District drivers are required to purchase is UM coverage. Mr. Miller believes that there is no good reason for requiring drivers to

purchase such insurance. He notes that UM coverage is not required in most jurisdictions. (AIPSO Ex. 2 at 21)

As with issue 8, OPC failed to brief or present any evidence pertaining to this issue. The Administration finds the testimony of Mr. Miller persuasive, and determines that the disparity between the statutory limits in the Metropolitan area does not result in excessive rates.

III. Findings of Fact and Conclusions of Law

Based on the foregoing discussion, the Superintendent of Insurance makes the following findings of fact:

1. The formula set forth above in section II.A.1 is the proper measure of a company's after-tax rate of return.

2. An after-tax rate of return of 12% on statutory surplus is appropriate for the assigned risk private passenger automobile insurance industry.

3. A premium to surplus ratio of 2 to 1 is the appropriate ratio for this proceeding.

4. The inclusion of a 5% contingency factor in the ratemaking formula is inappropriate.

5. The trend factors advocated by OPC are appropriate for use in this proceeding.

6. As regards the experience period for the UM and PIP coverages, the evidence presented by OPC was persuasive. A three year experience period provides more credible data.

7. The LDFs proposed by AIPSO are the appropriate LDFs for this proceeding.

8. A rate level increase of 7.6% will allow AIPSO to earn an appropriate rate of return.

9. A 7.6% increase allocated according to the principles of this order results in the following increases:

Coverage	Increase
Bodily Injury	24.6%
Property Injury	-9.2%
Personal Injury Protection	6.6%
Uninsured Motorist	60.0%
Comprehensive & Collision	-22.8%

10. The comparison between the MAIF rating factors and those used by DCAIP is unpersuasive.

11. The updated and trended indications indicate that an increase is necessary for the UM coverage.

12. AIPSO's estimate of acquisition and general expenses is appropriate for use in this proceeding.

13. AIPSO's expense loading factor is appropriate.

A. The rates filed by AIPSO on April 29, 1992, are "excessive" as that term is defined by the District of Columbia Code.

B. The rates filed by AIPSO on April 29, 1992, updated with calendar/accident year 1991 data, trended forward to September 1, 1993, and as adjusted herein, are neither "excessive, inadequate or unfairly discriminatory" as the same terms are defined by the District of Columbia Code.

IV. Decision & Order

It is therefore, this Twenty-fourth day of September 1993, ORDERED THAT:

1. The rates filed by AIPSO on April 29, 1992, are rejected.

2. The rates filed by AIPSO on April 29, 1992, trended forward to September 1, 1993, and as adjusted herein, are hereby approved.

3. Within ten (10) days of service of this Order, AIPSO shall file revised rate pages calculated in accordance with this Order. The Administration's Technical Agent and OPC shall have five (5) business days from the date the revised rate pages are filed in which to file comments or objections to the revised pages filed by AIPSO. Objections shall be limited to computational issues. The methodologies and assumptions set forth in this Order and, to the extent unmodified by this Order, those contained in AIPSO's original filing shall be the sole basis for the revised rate pages and any objections thereto.